

Letter of Findings: 01-20130460
Individual Income Tax
For Tax Years 2009 and 2010

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded by the publication of another document in the Indiana Register.

ISSUE

I. Individual Income Tax – Imposition.

Authority: I.R.C. § 61; I.R.C. § 1366; I.R.C. § 1367; I.R.C. § 1368; IC § 6-3-1-3.5; IC § 6-8.1-5-1; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138 (Ind. Tax Ct. 2010); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 2012); [45 IAC 3.1-1-66](#).

Taxpayers protest the additional income tax.

STATEMENT OF FACTS

Taxpayers, husband and wife, are two shareholders of an Indiana S corporation ("Corporation"). Corporation's gain or loss passes through to Taxpayers, and Taxpayers report the income or deduct the loss in their federal and Indiana individual income tax returns according to I.R.C. § 1366 and IC § 6-3-1-3.5.

In 2013, the Indiana Department of Revenue ("Department") conducted a Sales/Use Tax audit of Corporation's business records. Pursuant to the audit, the Department found that Corporation made various payments to Taxpayers to cover Taxpayers' personal expenditures. Thus, the Department conducted a separate investigation concerning Taxpayers' individual income tax on those specific payments. As a result of the investigation, the Department determined that Corporation made additional distributions to Taxpayers. Those additional distributions reduced Taxpayers' stock basis in Corporation below zero, and, as a result, created additional taxable income that was not reported on Taxpayers' individual income tax returns for the tax years 2009 and 2010 ("Tax Years at Issue"). The Department thus assessed Taxpayers additional income tax, interest, negligence penalty and underpayment penalty.

Taxpayers protested the proposed assessments. A phone hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Individual Income Tax – Imposition.

DISCUSSION

The Department assessed Taxpayers additional income tax on the ground that, during the Tax Years at Issue, Taxpayers, as shareholders of Corporation received additional distributions from Corporation but they did not have sufficient basis. As a result, the Department's investigation determined that those distributions were additional income to Taxpayers and were subject to Indiana individual income tax.

Taxpayers, to the contrary, claimed that the Department's assessments were overstated.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007); Indiana Dep't. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012). Thus, the taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's assessment is wrong. Poorly developed and non-cogent arguments are subject to waiver. Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480, 486, fn. 9 (Ind. Tax Ct. 2012).

In general, the Internal Revenue Code requires a taxpayer to report and pay his or her federal income tax when his or her gross income exceeds a certain amount. Gross income includes all income whatever source derived.

I.R.C. § 61(a). For state income tax purposes, the presumption is that a taxpayer properly and correctly files his or her federal income tax returns and, thus, to efficiently and effectively compute what is considered Indiana income tax, the Indiana income tax rules piggyback on the federal income tax statutes and regulations. Therefore, pursuant to IC § 6-3-1-3.5, the federal rules and case law are generally applicable to determine individual shareholder's tax liability. [45 IAC 3.1-1-66](#), in relevant part, further explains that:

Subchapter S corporation shareholders are taxed on their distributive shares of income at the individual income tax rate. The character of the income (as capital gains or ordinary income) also passes through to the shareholders.

I.R.C. § 1367 (as in effect for the Tax Years at Issue) provides:

(a) General rule.

(1) Increases in basis. The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:

- (A) the items of income described in subparagraph (A) of section 1366(a)(1),
- (B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1), and
- (C) the excess of the deductions for depletion over the basis of the property subject to depletion.

(2) Decreases in basis. **The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero)** by the sum of the following items determined with respect to the shareholder for such period:

- (A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,
- (B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),
- (C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1),
- (D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and
- (E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under section 613A(c)(11)(B).

The decrease under subparagraph (B) by reason of a charitable contribution (as defined in section 170(c)) of property shall be the amount equal to the shareholder's pro rata share of the adjusted basis of such property. . . .

(b) Special rules.

(1) Income items. An amount which is required to be included in the gross income of a shareholder and shown on his return shall be taken into account under subparagraph (A) or (B) of subsection (a)(1) only to the extent such amount is included in the shareholder's gross income on his return, increased or decreased by any adjustment of such amount in a redetermination of the shareholder's tax liability.

(2) Adjustments in basis of indebtedness.

(A) Reduction of basis. If for any taxable year the amounts specified in subparagraphs (B), (C), (D), and (E) of subsection (a)(2) exceed the amount which reduces the shareholder's basis to zero, such excess shall be applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder.

(B) Restoration of basis. If for any taxable year beginning after December 31, 1982, there is a reduction under subparagraph (A) in the shareholder's basis in the indebtedness of an S corporation to a shareholder, any net increase (after the application of paragraphs (1) and (2) of subsection (a)) for any subsequent taxable year shall be applied to restore such reduction in basis before any of it may be used to increase the shareholder's basis in the stock of the S corporation.

(3) Coordination with sections 165(g) and 166(d). This section and section 1366 shall be applied before the application of sections 165(g) and 166(d) to any taxable year of the shareholder or the corporation in which the security or debt becomes worthless.

(4) Adjustments in case of inherited stock.

(A) In general. If any person acquires stock in an S corporation by reason of the death of a decedent or by bequest, devise, or inheritance, section 691 shall be applied with respect to any item of income of the S corporation in the same manner as if the decedent had held directly his pro rata share of such item.

(B) Adjustments to basis. The basis determined under section 1014 of any stock in an S corporation shall be reduced by the portion of the value of the stock which is attributable to items constituting income

in respect of the decedent.

(Emphasis added).

I.R.C. § 1368 provides,

(a) General rule. A distribution of property made by an S corporation with respect to its stock to which (but for this subsection) section 301(c) would apply shall be treated in the manner provided in subsection (b) or (c), whichever applies.

(b) S corporation having no earnings and profits. In the case of a distribution described in subsection (a) by an S corporation which has no accumulated earnings and profits

(1) Amount applied against basis. The distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock.

(2) Amount in excess of basis. If the amount of the distribution exceeds the adjusted basis of the stock, such excess shall be treated as gain from the sale or exchange of property.

(c) S corporation having earnings and profits. In the case of a distribution described in subsection (a) by an S corporation which has accumulated earnings and profits

(1) Accumulated adjustments account. That portion of the distribution which does not exceed the accumulated adjustments account shall be treated in the manner provided by subsection (b).

(2) Dividend. That portion of the distribution which remains after the application of paragraph (1) shall be treated as a dividend to the extent it does not exceed the accumulated earnings and profits of the S corporation.

(3) Treatment of remainder. Any portion of the distribution remaining after the application of paragraph (2) of this subsection shall be treated in the manner provided by subsection (b).

Except to the extent provided in regulations, if the distributions during the taxable year exceed the amount in the accumulated adjustments account at the close of the taxable year, for purposes of this subsection, the balance of such account shall be allocated among such distributions in proportion to their respective sizes.

(d) Certain adjustments taken into account. Subsections (b) and (c) shall be applied by taking into account (to the extent proper)

(1) the adjustments to the basis of the shareholder's stock described in section 1367, and

(2) the adjustments to the accumulated adjustments account which are required by subsection (e)(1).

In the case of any distribution made during any taxable year, the adjusted basis of the stock shall be determined with regard to the adjustments provided in paragraph (1) of section 1367(a) for the taxable year.

(e) Definitions and special rules. For purposes of this section

(1) Accumulated adjustments account.

(A) In general. Except as otherwise provided in this paragraph, the term "accumulated adjustments account" means an account of the S corporation which is adjusted for the S period in a manner similar to the adjustments under section 1367 (except that no adjustment shall be made for income (and related expenses) which is exempt from tax under this title and the phrase "(but not below zero)" shall be disregarded in section 1367(a)(2)) and no adjustment shall be made for Federal taxes attributable to any taxable year in which the corporation was a C corporation.

(B) Amount of adjustment in the case of redemptions. In the case of any redemption which is treated as an exchange under section 302(a) or 303(a), the adjustment in the accumulated adjustments account shall be an amount which bears the same ratio to the balance in such account as the number of shares redeemed in such redemption bears to the number of shares of stock in the corporation immediately before such redemption.

(C) Net loss for year disregarded.

(i) In general. In applying this section to distributions made during any taxable year, the amount in the accumulated adjustments account as of the close of such taxable year shall be determined without regard to any net negative adjustment for such taxable year.

(ii) Net negative adjustment. For purposes of clause (i), the term "net negative adjustment" means, with respect to any taxable year, the excess (if any) of

(I) the reductions in the account for the taxable year (other than for distributions), over

(II) the increases in such account for such taxable year.

(2) S period. The term "S period" means the most recent continuous period during which the corporation has been an S corporation. Such period shall not include any taxable year beginning before January 1,

1983.

(3) Election to distribute earnings first.

(A) In general. An S corporation may, with the consent of all of its affected shareholders, elect to have paragraph (1) of subsection (c) not apply to all distributions made during the taxable year for which the election is made.

(B) Affected shareholder. For purposes of subparagraph (A), the term "affected shareholder" means any shareholder to whom a distribution is made by the S corporation during the taxable year.

(f) Restricted bank director stock. If a director receives a distribution (not in part or full payment in exchange for stock) from an S corporation with respect to any restricted bank director stock (as defined in section 1361(f)), the amount of such distribution

(1) shall be includible in gross income of the director, and

(2) shall be deductible by the corporation for the taxable year of such corporation in which or with which ends the taxable year in which such amount is included in the gross income of the director.

In this instance, Taxpayers asserted that the Department's assessments were overstated because not all the listed payments were paid to Taxpayers for their personal expenses. In addition to copies of Corporation's unaudited qualified Accountant's Compilation Report for the Tax Years at issue ("Report"), Taxpayers submitted copies of Corporation's bank statements for its Money Market Account 101XXXXX for the Tax Years at Issue to support their protest.

Upon reviewing Taxpayers' supporting documentation, however, the Department is not able to agree that the Department's assessments were overstated. Specifically, in this instance, Taxpayers stated that since Corporation "is a small family-owned business, the owners [i.e., Taxpayers] put in money and take out money as needed all the time." Thus, there is no dispute that, during the Tax Years at Issue, Corporation made various distributions to Taxpayers when Taxpayers took out money from Corporation for their personal expenses. Also, there is no dispute as to the shareholder's basis established in Corporation's 1120S returns for the Tax Years at Issue for each of Corporation's shareholders, including Taxpayers. Rather, the Department's investigation report listed various payments made from Corporation to Taxpayers for their personal expenses, and determined that these payments, as additional distributions to Taxpayers, reduced both Taxpayers' basis in Corporation below zero. As a result, the Department's investigation report concluded that these distributions created additional taxable income to Taxpayers because the basis could not be below zero.

In this instance, Taxpayers made various statements disputing the Department's assessments in their July 23, 2013, protest letters. For example, the Department determined that Corporation made a distribution to Taxpayers, in the amount of \$19,302.24, in December 2009. Taxpayers asserted that "Accounts Receivable Shareholders – 55[percent] shareholder percentage in the amount of \$19,302.24 was paid back in the tax year 2010." However, Taxpayers' documentation failed to demonstrate that this payment was not distribution to Taxpayers for the Tax Years at Issue. Specifically, Corporation's unaudited qualified Report only contained Corporation's "Year-End Financial Statements," which included summaries of "Statement of Assets, Liabilities, & Equity," "Statement of Related Earnings," and "Statement of Revenue and Expenses" for the Tax Years at Issue. Corporation's Report further stated for the accountant who compiled the information for Corporation, a disclaimer, that he has "not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with the income tax basis of accounting." Additionally, Corporation's monthly bank statements simply contained monthly summaries of check deposits, withdraws, and account balances concerning its Money Market Account 101XXXXX. Taxpayers' documentation neither explained which of Corporation's payment or payments were paid to Taxpayers for their personal expenses, nor those payments which would not have been considered as distributions to Taxpayers.

As mentioned earlier, Taxpayers bear the burden of proving that the Department's assessments are wrong and are required to provide documentation explaining and supporting their protest. Given the totality of the circumstances, in the absence of other supporting documentation, the Department is not able to agree that Taxpayers meet their burden of proof demonstrating that the Department's assessments were not correct.

In short, Taxpayers' protest is respectfully denied.

FINDING

Taxpayers' protest on the imposition of additional income tax is respectfully denied.

